DOW THEORY LETTERS INC.

SAVE

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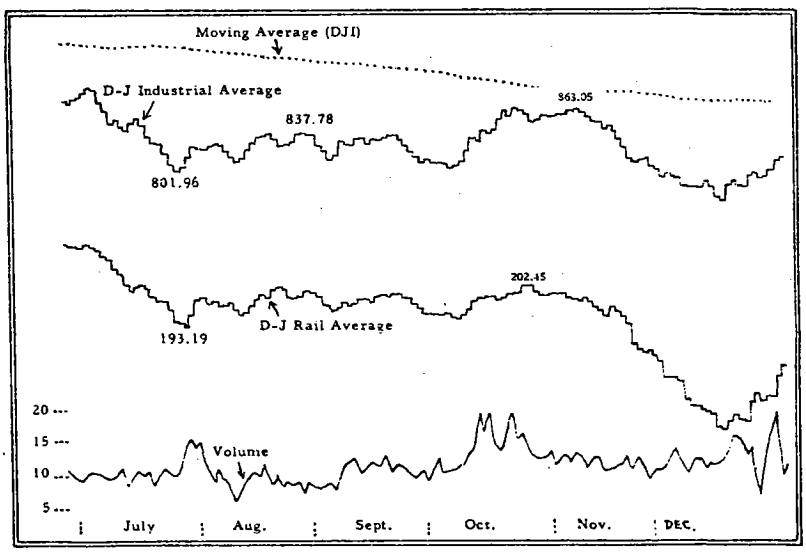
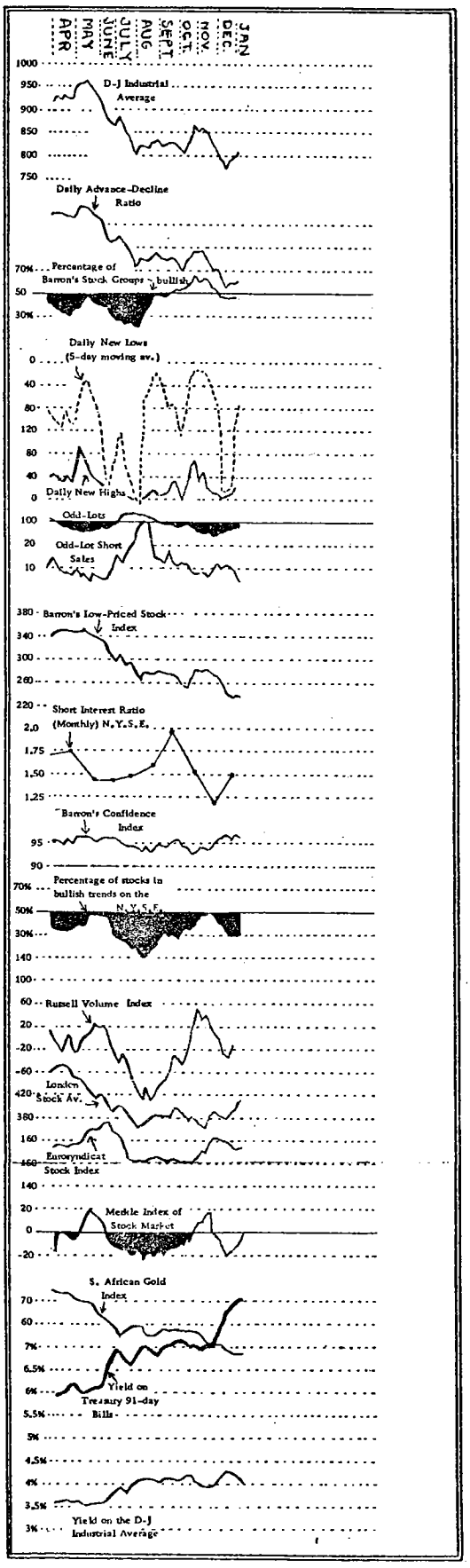
THE MARKET: One is always tempted, as a new year begins, to put his most optimistic foot forward. Unfortunately, my job does not entail serving pap, hopes or dreams to subscribers. As I see my job, it is to stay in reality. And reality is that we are now in the midst of a major primary bear market, a bear market which will be four years old on February 9, 1970.

Historically, bear markets tend to last 1/3 to 1/2 as long as the preceding bull markets. Since this bear market is in the process of correcting the 17-year bull market of 1949 to 1966, a rough rule-of-thumb would be that the bear market could last five to eight years (and I will be optimistic in that I hope it lasts nearer to five than eight). However, the interesting part of the picture is that with four years out of the way, the worst the Dow Industrials have done is to decline from their 1966 peak of 995.15 to their 1966 low of 744.32, a total drop of 251 points.

The year 1969 saw both the Utility and the Rail (now the Transportation) Averages penetrate their 1966 lows. My guess is that 1970 will see Industrials confirm by breaking their own 1966 (744.32) low. Furthermore, the bear market has been relatively "polite" during its first four years. No panic has developed, no crash has been seen. The Industrial Average in total has fallen only 25%. Again, I will guess that the remaining years of the bear market are very likely to produce enough violence to make up for its first four polite years of existence.

As the old year ends and the New Year enters, signs of the bear multiply. The auto industry expects the lowest car production in eight years (off 22% from last year). Stock brokers bonuses are cut, housing production caves in, steel mill production slides and steel stocks grow, building awards (November) show a 9% drop from the year before, the Government's leading indicators drop, and treasury bills and bonds fall to record lows.





All this has not been lost on Washington's brighter members. In the face of higher spending and an inflationary new tax bill, the President's hoped-for $6 billion budget surplus fades into oblivion. Already, one economist (and one of the best) with close ties to the Administration forecasts a deficit. Alan Greenspan believes spending for the new fiscal year will be around $203 billion while revenues will drop off to $199 billion, producing a $4 billion deficit. Personally, I believe Greenspan is optimistic regarding the revenue side, and I think that the deficit is going to be bigger than $4 billion.

If a deficit materializes, it will mean that the Government will have to come into the market for more money. That will produce further pressure on the already collapsed bond market, higher mortgage rates (mortgages are competitive with bonds) and further troubles for housing.

Finally, I want to draw attention to the phenomenon of changing mass psychology within a bear market. So far, the public has exhibited remarkable faith in the Government and its wisdom. It's an empirical faith, born out of experience. There has been no collapse or depression since the 1940's. This is contra to all prior U.S. history, which shows that a quarter century has never passed without some sort of financial collapse. How did it happen? The public is only too happy to give full credit to the politicians, and the politicians are only too happy to take full credit for this remarkable period. However, no one thinks of the cost (for instance, in debt and inflation) which has gone into producing this era of "prosperity". But now the costs are beginning to become more obvious. Interest rates are being questioned, military budgets(for the first time) are being questioned, the basis for prosperity itself is being questioned.

I believe that from here on during the bear market we are going to see a change in public sentiment from euphoria and mindless "faith" to increasing scepticism, questioning and finally pessimism. This coming swing in psychology is the "hidden factor" which no economist can measure, no computer can forecast and no politician can plan for. It is the largest ingredient in any bear market; it is the one which produces the surprises. We will watch for it during 1970. For just as the rise of bullishness during 1949-66 threw all the forecasts into a cocked hat, so the rise of bearishness over the next few years could make a mockery of all the economic forecasts and their authors.

INTELLECTUAL BANKRUPTCY: The year 1970 is being ushered in with the battle of the "big name economists." Arthur Burns seems to be hinting that, as Chairman of the Federal Reserve Board, he might lean towards easier credit since he rightly wants to avoid a recession. Milton Friedman, "Mr. Money Supply," states that if the current tough money conditions continue, a severe recession will arrive in 1970. Not so, says sage Pierre Rinfret, regardless of tight money, 1970 is going to see a boom that will knock your eyes out. Paul McCracken, President Nixon's top adviser, announced last week that "we can't stay on this course indefinitely without having the economy drift further below its potential." Perhaps the best words on the subject were spoken by Standard & Poor's top technician, Bill Jiler: "It is confusing. I honestly have to say that they all make sense to me."

Personally, I was more struck by a few sentences from the famous Babson Report last week than I was with any of the pronouncements by the glamor-economists. "The social and scientific plums that are being dangled before our eyes," says Babsons, "to be gathered in the 1970's, may never be grasped. For the beast of inflation may devour them prematurely. We're not predicting the day or the hour or the final outcome. But we are forecasting that the history of the seventies will be written in terms of whether man mastered inflation.....or inflation, man."

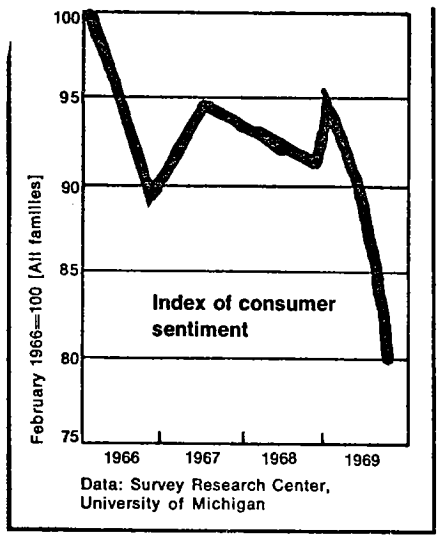
I must say that I agree with Babsons' appraisal. But then again, the question is: How can inflation be mastered? Try as it may, the Administration does not seem to be able to stem inflation without a recession. The never-ending rises in labor costs, production costs and interest rates are being passed on in the form of higher prices and further inflation. High interest rates in the face of full employment and good business does not seem to be enough to halt inflation.

What will happen if the Fed becomes worried about the economic outlook and starts to open the money faucets again? My guess is that today's galloping inflation would turn into sky-rocketing inflation. But what if wage and price controls were administered along with an increasing money supply? This appears to be an academic question, since the Administration has taken a firm stand against controls, if for no other than political reasons.

Then what is the answer, and where lies the way out? As I see it, one thing that is fated to happen is that the public is going to lose confidence increasingly in the entire situation. Inflation is simply not a bullish force any longer, and in proof I offer this little chart of Consumers' Buying Intentions (page 3) as polled by the University of Michigan. This chart is telling me that the consumer has passed over the "inflation-optimism" peak, and that he is no longer buying simply because he believes prices will be higher six months from now. The little man is confused, and he is losing confidence.

President Nixon knows this and so does everyone else in the Administration. The Administration's dream of halting inflation in some painless manner has, so far, proved futile. Yet they can't let inflation continue unabated. It seems to me that Washington has reached a sort of intellectual bankruptcy, and they are to be damned if they do, damned if they don't.

The best I see ahead is a period of "economic suspension," a sort of drift toward more of the same. And this type of policy will only succeed in building more excesses into the economy, in throwing more and more factors out-of-kilter. This might allow for more upside action by the market, until it is seen that the "suspension" policy is a fraud— not a solution.

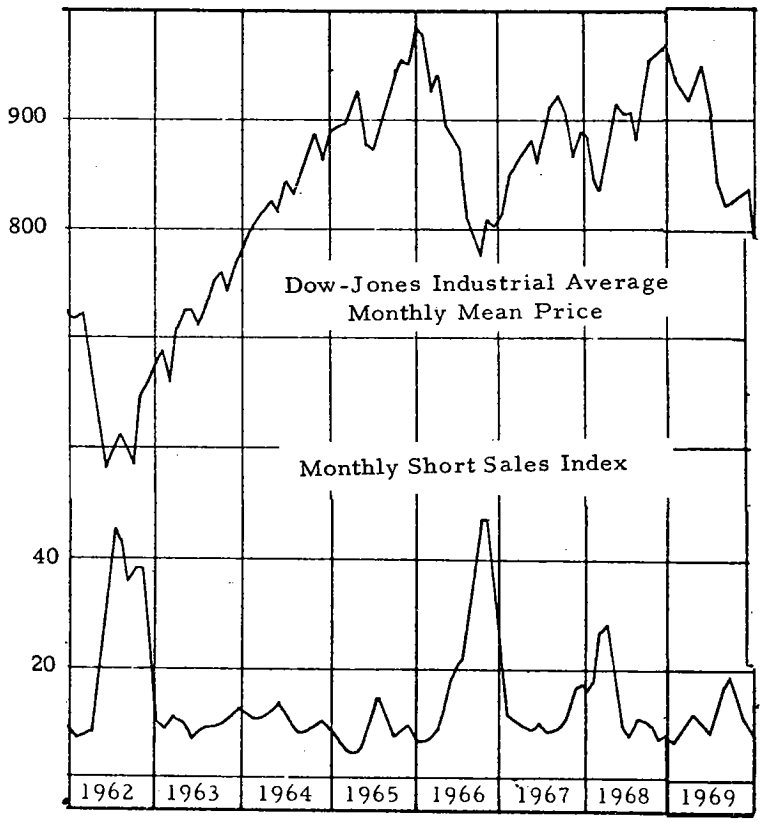


But in the end I am convinced that the primary bear market will have its way, it will express itself as surely as the night follows the day. And in the meantime, my subscribers and I will have to wait it out. We will have to exert all our stamina and moral fortitude, all our patience. The market from the 1966 bull market high to the present has been as treacherous as any in decades. If you don't believe it, reread my piece on the mutual funds in the last Letter. I hereby predict that the market over the next few years will be much more treacherous and much more costly. Why? Simply because the fundamental problems are not being solved. They are being manipulated, talked away, swept under the rug or ignored.

BEARISH PUBLIC? I have mentioned the surprising lack of odd-lot shorting on the 1969 decline, but for me only an actual chart can put the picture into proper perspective. I have borrowed a chart from Mr. Garfield Drew's famous Odd-lot report, and this chart shows the monthly ratio of odd-lot short sales to total odd-lot sales. The "Index" shown on the chart is the three-month moving average of the monthly figures.

I am always interested in the public's reaction to a market rise or decline, and it is particularly valuable to compare the reaction to a similar response in the recent past. Thus, for instance, I would be much more interested in comparing the 1969 reaction with the 1968 reaction— rather than say the 1969 reaction with the 1930 reaction.

Note that in 1962 the odd-lot index jumped to 45.9 before the bottom was touched in the market. The 45.9 figure represented the highest monthly (Index) figure in Drew's historical computations going back to 1939. Thus we can say that the odd-lot public in 1962 was extremely bearish and very willing to short the market.



The next odd-lot shorting peak came in October, 1966 for the Index. That figure was an astounding 48.9, indicating that an even higher degree of bearishness near the bottom than was the case in 1962.

From then on, it seems to be a case of the odd-lot shorter becoming increasingly doubtful of a profitable or major decline. The sell-off which began in late-1967 terminated in March, 1968. The March Index figure for odd-lot short sales was 27.3, a respectable figure but far below those of 1962 and 1966. This may be explained away since the 1967-68 decline in the market was not nearly as extensive as the 1962 or 1966 affair.

The 1969 odd-lot short response to a 200 point drop in the Dow can hardly be explained away in the 1968 manner. The peak for the Short Index arrived in September, 1969, at a figure of 18.3. By any reckoning, this was an extremely mild response to a costly, extended year-long decline in the market.

My only conclusion is that the sub-standard odd-lot shorting of 1969 indicates far too little bearishness to support a major advance. A rally from the 1969 lows may well be in order, but I would expect the

odd-lot Index to rise into the 30 to 45 area before enough bearishness is indicated to support a major upward correction. From the odd-lot short Index standpoint, the market was far from sold-out at the 1969 lows. My guess is that some time in 1970 we will see a decline which will bring out the odd-lot short sellers in large numbers. At that point, the stage could be set for a sizable upward correction.

FOR 1970: I was interested in the article in the December 22 issue of U.S. News & World Report entitled "Size-up of 1970." This article was a tabulation of questions put to 700 leading investment bankers. I'm going to be contrary and state that in general the majority of professional opinion is wrong. No, I'm not slighting the amateurs, the majority of amateur opinion is also usually wrong, but maybe it's more dramatic when the professionals go on the line.

To the question, "What do you expect in the broad trend of business for 1970?" 391 bankers said that business would be level or up in 1970, while 303 said that there would be a downturn. The next question was: "Do you expect price inflation to be slowed in 1970?" To that question 664 bankers said that inflation would be moderated to some degree, while only 22 bankers thought that inflation would be stopped or that actual deflation would set in.

Their last question interested me most. "Where will the Dow-Jones Industrial Average be at mid-1970?" There were various ranges offered, but the net result was that 647 bankers believed that the Dow would be above 750 by mid-1970 while only 40 thought the Dow would be below 750. That response struck me as amazing. It means that only 6% of the bankers thought the Dow will be under 750 by mid-1970 while a whopping 94% thought the Dow would be at 750 or better.

Thus, it appears to me that the bankers are extremely bullish and have taken it for granted that the year 1969 saw the end of the bear market. This conclusion is particularly dramatic since a study of similar polls indicates that people tend to be guided by the most recent past. The market has been going down for almost a solid year, that is the recent past. Normally, following the 1969 type of action I would expect people (including bankers) to be bearish and to feel that the downward trend will continue. No such thing. With 6% of the bankers believing that the Dow will be under 750 by mid-1970, we can say that the banking fraternity is extremely bullish.

This brand of bullish psychology might also explain why we have had so few odd-lot shorts during 1969. The public is obviously as bullish as the professionals, and the public's low level of short selling indicates that they are not planning on scalping any profits on the downside simply because they do not believe that any profitable declines lie ahead.

SUNDRY ITEMS: In Letter 447 I included a study of the "Most Active Stocks" and the implications of this index for the market. Last week I received a letter from the gentleman who originated this study and the same man who presented this study in the April 24, 1969, issue of Barron's.

I am going to quote from the letter he wrote me: "Getting back to the most actives, I have sixteen years of date going back to January 1, 1954, also a few scattered years prior to that date. 1969 will be the most negative year of the sixteen and the only one wherein negative weeks exceeded positive ones (i. e., negative weeks are those in which a majority of the 20-most active stocks closed down). The premise may be wrong, which only time will tell, but my feeling is that massive distribution has been taking place and that it is continuing."

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At the recent annual convention of Investment Bankers, Pierre Rinfret, famed economist, appeared on a panel discussion. I thought this question and answer would interest my subscribers: Moderator ...."Dr. Rinfret, you have been around the country and in your studies made a strong case against the validity of the figures and claims of the Nixon Administration in the inflation area. Would you care to expand on this?"

Dr. Rinfret: "Well, very, very briefly, because that's a separate speech and a long one. I find it difficult to conceive of an anti-inflation fight which includes four key elements of a personal tax cut, a corporate tax cut, a Social Security benefit increase, and an increase in government spending. If that's anti-inflationary, I don't want to be around when they get expansionary."

* * * *

Mankind now spends $174 billion a year on arms. The NATO nations spend $103 billion, the Warsaw pact countries spend $43 billion, the U. S. itself spends around $80 billion. Thus arms spending today has reached the level of total madness and is about the same as was spent during World War II (on an annual basis).

Last week we read of a $20 billion "overrun" in the cost of certain U.S. arms. Overrun is military gibberish for costs which go over originally estimated contract costs. Maybe the following will help readers understand what is going on in terms of something understandable. If you told your wife to go out and spend $1,000 every day seven days per week, do you know how long it would take her to spend $1 billion? It would take 2,776 years. Let's take another example. Let's put a 50 pound field pack of one dollar bills on the back of a soldier. How many soldiers with out 50 pound packs would it require to carry $1 billion dollars? Well, it would require 42,500 men.

By the way, while I'm at it here's something else which angers me. The Pentagon's Public Affairs fund is now $27 million. This is publicity and "image" money which is received from the tax-payers, and much of this publicity will be aimed at propagandizing the public towards future fat military budgets. Thus, you and I pay for the production of the propaganda which is aimed at getting us to pay more for military spending. How long do you think nonsense like this can last?

* * * *

The latest figure for the short interest ratio in the 30 Dow stocks is a December, 1969 reading of .74. Thus the Dow short interest ratio has held under the critical 1.0 level for 22 out of the last 24 months. This is the longest period of bearish below 1.0 figures in the history of this Index going back to 1931.

* * * *

Many subscribers file these reports as a sort of Wall Street History. I include three bond prospectuses of late 1969 for the scrapbook, and I have no doubt that this page will elicit gasps from future generations. The three offerings are from highly regarded utility companies, and in each case the bond coupons are 9% or better. When this bear market in bonds is over, it could be 50 to 100 years before we see bonds with comparable yields again.

$20 Billion Overrun Bared In Arms Costs

WASHINGTON (AP) — Major U.S. weapons systems are costing at least $20 billion more than original estimates and no one man knows the total number of systems being acquired or their costs, Congress was told yesterday.

One example cited was a new Navy deep-sea submarine rescue craft, the estimated cost of which has jumped from $3 million to more than $77 million each. The estimate first was $36 million for 12 and is now $463 million for six, the House-Senate economy subcommittee was told.

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$15,000,000

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Price 100%

Plus accrued interest from December 1, 1969

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NEW ISSUE December 5, 1969

$20,000,000

Columbus and Southern Ohio Electric Company

First Mortgage Bonds, 9% Series due 1999

Price 101.04%

plus accrued interest from December 1, 1969

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NEW ISSUE December 2, 1969

$10,000,000

Northern States Power Company

(a Wisconsin corporation)

First Mortgage Bonds, Series due December 1, 1999, 9¼%

Price 100.50%

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